# ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Chesbro | Analyst: Marion Mann DeJong | Bill Number: SB 93

Related Bills: See Legislative History | Telephone: (916) 845-6979 | Introduced Date: 12/07/98

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Taxpayer Bill of Rights/Conformity

SUMMARY OF BILL

This bill would do the following:

1. Eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax. (See Personal Exemption Credits/AMT on page 3.)

2. Make a technical correction to remove language from the credit ordering provisions that specifically place the renter's credit with refundable credits and do not reflect the change made by AB 2797 (Stats. 1998, Ch. 322) to make the renter's credit nonrefundable. (See Credit Order/Renter's Credit on page 6.)

3. Conform to the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act) technical changes relating to the exclusion of capital gains on the sale of a principal residence. (See Capital Gain Exclusion/Principal Residence on page 7.)

4. Conform to the IRS Reform Act technical changes relating to Roth individual retirement accounts (IRAs). (See Roth IRAs on page 9.)

5. Expand innocent spouse protections by conforming to the IRS Reform Act provisions relating to innocent spouses. (See Innocent Spouse on page 13.)

6. Provide relief to an employee whose employer withheld delinquent taxes from the employee's pay, pursuant to an earnings withholding order from the Franchise Tax Board (FTB), but failed to remit the amounts to FTB. (See Employee Relief/Unremitted Withholdings on page 15.)

7. Conform to the IRS Reform Act provision to suspend the statute of limitations (SOL) for certain refund claims for periods during which the taxpayer is "financially disabled." (See SOL/Disabled Taxpayer on page 17.)

8. Provide FTB administrative authority to compromise a tax debt similar to the IRS's current offers in compromise authority. (See Offers In Compromise on page 18.)

Board Position:

| | | |
|---|---|---|
| ____ S | ____ NA | ____ NP |
| ____ SA | ____ O | ____ NAR |
| ____ N | ____ OUA | X PENDING |

| Department Director | Date |
|---|---|
| **Gerald Goldberg** | **02/04/1999** |

## EFFECTIVE DATE

As a tax levy this bill would become effective immediately; however, the operative dates of the specific provisions would vary, as discussed in the analysis.

## LEGISLATIVE HISTORY

On July 22, 1998, President Clinton signed H.R. 2676, the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act). The IRS Reform Act provides for a massive reorganization of the way the IRS does business and creates a board of directors to help oversee the agency. The IRS Reform Act also provides various taxpayer protections (e.g., innocent spouse and disabled taxpayer relief) and instructs the IRS to promote and improve its electronic filing programs. Finally, the IRS Reform Act eliminates the 18-month holding period for long-term capital gains and contains several technical corrections to the Taxpayer Relief Act of 1997.

AB 1469 (1998) was amended to conform to selected parts of the IRS Reform Act and contained other taxpayer rights provisions. The Governor vetoed AB 1469 because of another provision contained in that bill. That provision is not contained in SB 93.

## SUMMARY OF TAX REVENUE

| Provision | Revenue Impact |
|---|---|
| 1. Personal Exemption Credit/AMT | ($1.5) Million annually |
| 2. Credit Order/Renter's Credit | No Impact |
| 3. Capital Gain Exclusion/Personal Residence | No Impact |
| 4. Roth IRAs | Minor Revenue Losses |
| 5. Innocent Spouse | Minor Revenue Losses – ($500,000) annually |
| 6. Employee Relief/Unremitted Withholdings | Negligible Losses – ($25,000) annually |
| 7. SOL/Disabled Taxpayer | ($1) Million annually |
| 8. Officers In Compromise | Minimal Revenue Savings - $40,000 annually |
| **TOTAL** | **$3 Million annually** |

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

## BOARD POSITION

Pending.

## 1. Personal Exemption Credits/AMT

OPERATIVE DATE

This provision would apply to taxable years beginning on or after January 1, 1999.

PROGRAM HISTORY/BACKGROUND

In 1987, California enacted legislation that established an Alternative Minimum Tax (AMT) in lieu of the previous tax on preference income. The California legislation substantially conformed state law to the AMT provisions in effect at the federal level, which had been adopted as part of the Tax Reform Act of 1986. The AMT at both the federal and state levels was established to ensure that no taxpayers with substantial economic income could completely avoid tax liability by using exclusions, deductions, and credits (tax preference items). As discussed below, taxpayers are allowed an AMT exemption deduction in computing AMT. Prior to 1997, the AMT exemption deduction amounts were: $40,000 for married taxpayers filing joint returns; $30,000 for individuals filing as either single or as a head of household; and $20,000 for married taxpayers filing separate returns. These AMT exemption deduction amounts were increased in 1997 to $45,000 for married taxpayers filing joint returns; $33,750 for individuals filing as either single or as a head of household; and $22,500 for married taxpayers filing separate returns. Also, the AMT exemption deduction amounts will be adjusted for inflation after the 1999 taxable year.

The AMT essentially is a mechanism for recapturing some of the tax benefits available to higher-income taxpayers. Although these tax benefits are allowed under current law, the AMT effectively limits the extent to which, when taken collectively, they can reduce tax liability.

The AMT can affect tax liability in either or both of two ways: First, an AMT liability can be assessed in excess of the taxpayer’s regular tax liability. Second, the AMT calculation can result in a reduction in the amount of tax credits that a taxpayer is allowed, thus effectively increasing regular tax.

Differences between the structure of state and federal laws necessitate some differences between state and federal AMT provisions. One difference is the treatment of the personal exemption. State law allows a personal exemption in the form of a credit; federal law provides a personal exemption in the form of a deduction. For federal AMT purposes, the personal exemption deduction may not be used in the calculation of alternative minimum taxable income (AMTI). State law conformed to this federal provision by not allowing the personal exemption credit to reduce regular tax below tentative minimum tax (TMT).

To claim personal exemption credits, taxpayers must first calculate their TMT to determine whether their credits will be limited. The interaction of AMT with the personal exemption credit adds complexity to personal income tax return preparation for approximately 3 million taxpayers who must make the calculation only to determine that their personal exemption credit is not limited by TMT. This interaction also increases the tax liability of approximately 30,000 moderate-income taxpayers whose personal exemption credits would be reduced by the TMT interaction.

Prior to 1997, each exemption credit amount (personal, dependent, blind) was the same. For the 1997 taxable year, each exemption credit amount was $68. The credit amount is adjusted annually for inflation.

In 1997, SB 1233 (Ch. 612) increased the dependent exemption credit amount to $120 for the 1998 taxable year and to $222 beginning in the 1999 taxable year. The increased credit would not be adjusted for inflation for the 1999 taxable year.

In 1998, AB 2797 (Ch. 322) increased the dependent exemption credit amount from $120 to $253 for the 1998 taxable year and from $222 to $227 for the 1999 taxable year and thereafter. The increased credit will be adjusted for inflation after the 1999 taxable year.

## SPECIFIC FINDINGS

**Existing federal law** provides five tax brackets ranging from 15% to 39.6%. It also provides a two-tiered personal income AMT rate system. The AMT rate is 26% of the "taxable excess" that does not exceed $175,000 and 28% of the "taxable excess" that exceeds $175,000. "Taxable excess" is the amount of alternative minimum taxable income (AMTI) that exceeds the exemption deduction. The exemption deduction allowed against AMTI is: $45,000 for married taxpayers filing joint; $33,750 for single or head of household taxpayers; and $22,500 for married taxpayers filing separate.

**Prior to 1998, under federal law** the nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer’s credit) were allowed only to extent that the individual’s regular tax liability exceeded the individual’s TMT. For tax years beginning in 1998, federal law allows the nonrefundable personal credits to offset the individual’s regular tax in full.

**Existing state law** provides six tax brackets ranging from 1% to 9.3% and a personal income AMT rate of 7%.

California AMT is calculated by increasing regular taxable income by specific tax preference items and making other adjustments for items for which treatment differs under AMT rules. The resulting figure is AMTI, from which an AMT exemption deduction is subtracted. The AMT exemption deduction amounts vary depending on filing status and are indexed annually for inflation. For 1997, the AMT exemption deduction amounts are: $45,000 for married taxpayers filing joint returns; $33,750 for individuals filing as either single or as a head of household; and $22,500 for married taxpayers filing separate returns. The exemptions are phased out for taxpayers with adjusted gross income over specified amounts. The excess of AMTI over the AMT exemption deduction, multiplied by the 7% AMT rate, is TMT. Tentative minimum tax is compared to regular tax before credits; the amount by which TMT exceeds regular tax before credits is the alternative minimum tax. The Personal Income Tax Law (PITL) provides a variety of credits, some of which may be used to reduce the regular tax below TMT. However, the law specifies that certain credits cannot reduce regular tax to an amount less than the TMT. In effect, taxpayers lose some of the value of the credits that may not be carried forward and may not reduce regular tax below TMT.

**Existing state law** provides various exemption credits against tax, including a personal exemption and exemptions for dependents, blind persons, and individuals 65 or older. Exemption credit amounts are allowed as follows for the 1998 taxable year:

| Exemption Type | Amount (1998) |
|---|---|
| Personal | $70 |
| Blind | $70 |
| Dependent | $253 |

The exemption credit amounts are indexed annually for inflation as measured by changes in the California Consumer Price Index. Exemption credits are not refundable and may not be carried over to future years. Exemption credits are subject to two limitations:

1. Exemption credits begin to phase out at federal AGI levels over the amounts listed below:

| Filing Status | AGI (1998) |
|---|---|
| Single/Head of Household | $161,044 |
| Married Filing Separate | $107,362 |
| Married Filing Joint | $214,725 |

2. Exemption credits are limited to the amount by which regular tax before credits exceeds tentative minimum tax (TMT).

**This provision** would eliminate the tentative minimum tax limitation on personal exemption credits by allowing the personal exemption credits to reduce regular tax below tentative minimum tax.

### Policy Considerations

This bill would ensure that 30,000 additional moderate-income taxpayers would be able to take full advantage of recently increased dependent exemption amounts. Also, this bill would reduce the complexity of filing a PIT return by eliminating the need for moderate-income taxpayers, with no preferences, to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

### Implementation Considerations

The implementation of this provision would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

## FISCAL IMPACT

### Departmental Costs

To the extent this proposal would reduce the number of telephone calls from taxpayers regarding how to complete the complex AMT calculation (Schedule P) and the number of errors that must be addressed during return processing, it would generate significant cost savings.

Tax Revenue Estimate

Based on tax model simulations, eliminating the TMT interaction with regard to all exemption credits would result in revenue losses of $1.5 million annually beginning with the 1999-2000 fiscal year, benefiting approximately 30,000 filers.

This proposal would eliminate the need for approximately 3 million taxpayers to complete the AMT personal exemption credit limitation worksheet to determine whether their personal exemption credits are limited.

## 2. Credit Ordering/Renter's Credit

OPERATIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 1999.

BACKGROUND

AB 2797 (Stats. 1998, Ch. 322) changed the renter's credit from a refundable tax credit to a nonrefundable tax credit. However, language in the credit ordering provision (Section 17039) that specifically places the renter's credit in the class of refundable credits was not removed.

SPECIFIC FINDINGS

**Current state law** specifies the order tax credits are applied against net tax as follows:

- Credits that do not contain carryover or refundable provisions, except for taxes paid to other states and the alternative minimum tax credit.
- Credits that contain carryover provisions but do not contain refundable provisions.
- The alternative minimum tax credit.
- Credits for taxes paid to other states.
- Credits that contain refundable provisions but do not contain carryover provisions.

**Current law** specifically includes renter's credit as a credit that contains refundable provisions but not carryover provisions even though the renter's credit is no longer refundable.

**This provision** would remove language that specifically includes the renter's credit as a credit that contains refundable provisions but not carryover provisions.

Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department's costs.

Tax Revenue Estimate

As a technical correction, this provision would not impact PIT revenues.

## 3. Capital Gain Exclusion/Principal Residence

OPERATIVE DATE

This provision would be operative on the same dates the federal changes are operative.

BACKGROUND

Under both **California and federal law,** a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). To be eligible for the exclusion, a taxpayer must have owned the residence and used it as a principal residence for at least two years during the five years prior to the sale or exchange.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude $500,000 of gain on their joint return. Special rules apply regarding the sale of a remainder interest, multiple family dwellings (e.g., cooperative housing corporations, co-ops and condominiums), involuntary conversions, and taxpayers residing in nursing homes.

An additional special rule applies to a taxpayer who fails to meet the requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances. The taxpayer is able to exclude part of the gain recognized. The law as enacted could be interpreted to limit the exclusion to the fraction of the taxpayer's realized gain on the sale equal to the fraction of two years that the requirements are met. Congress has indicated in committee reports that it was intended to exclude the fraction of the $250,000 ($500,000 for joint filers) equal to the portion of the two-year period that the requirements were met.

SPECIFIC FINDINGS

The **IRS Reform Act** made technical changes to the law regarding the exclusion of gain from the sale of a personal residence. The technical changes are:

- Proration - Exclusion of Gain. The **IRS Reform Act** corrected the provision relating to the proration of the exclusion in the case where the taxpayer does not meet the two-year ownership and use requirements if the sale is due to a change in place of employment, health, or unforeseen circumstances. The technical correction provides that the $250,000 or $500,000 exclusion, not the realized gain, is prorated for a taxpayer who does not meet the two-year ownership and use requirements and the sale is due to a change in place of employment, health, or unforeseen circumstances. This provision is effective for sales and exchanges after May 6, 1997.

- Exclusion - Joint Returns. The **IRS Reform Act** corrects the provision relating to the computation of the exclusion to clarify that the limit on the amount of excludable gain is computed separately for each spouse in the case of married individuals filing a joint return who fail to qualify for the $500,000 exclusion for gain on a residence because they do not satisfy the two-year ownership test, two-year use test, and the prohibition on any other sale or exchange within the last two years. Thus, the maximum exclusion for such a couple is equal to the sum of the exclusions to which each spouse would otherwise be entitled if they were not married. Each spouse is treated as owning the property during the period that either spouse owned the property. This provision is effective for sales and exchanges after May 6, 1997.

- Election of Prior Law - Sales or Exchanges on Enactment Date. The **IRS Reform Act** corrects the provision relating to the ability of a taxpayer to elect to apply prior law to a sale or exchange occurring on August 5, 1997, as well as to sales and exchanges occurring before August 5, 1997. Thus, taxpayers who sold or exchanged a home on or before August 5, 1997, could choose to use the $125,000 once-in-a-lifetime exclusion for taxpayers age 55 or over or the rollover-of-gain rule for homes that are replaced within the replacement period.

The Internal Revenue Service anticipated the above technical corrections and interpreted the law as Congress intended it. The 1997 federal form 2119 (Sale of Your Home) was drafted with the above three changes incorporated; therefore, taxpayers will not be required to file amended returns.

**California law** is in conformity with the federal rules regarding the exclusion of gain from the sale of a personal residence prior to the three technical changes made by the IRS Reform Act.

**This provision** would conform to the three technical changes discussed above with the same federal effective dates. California does not have a separate form but uses the federal form 2119; thus, taxpayers affected by the changes would not need to file an amended return.

### Implementation Considerations

Implementation of this provision would occur during the department's normal annual system update.

## FISCAL IMPACT

### Departmental Costs

This provision would not significantly impact the department's costs.

### Tax Revenue Estimate

As a technical correction, this provision would not impact PIT revenues.

# 4. Roth IRAs

## OPERATIVE DATE

This provision would be operative for taxable years beginning on or after January 1, 1999.

## BACKGROUND

Beginning in 1998, **federal and California law** provide for a new type of IRA, called a Roth IRA. A Roth IRA differs from other IRAs in that the tax advantages are "backloaded." Contributions to a Roth IRA are not tax deductible. Instead, the IRA earnings (e.g., interest and dividends) are distributed tax free (provided that certain requirements are met). To be treated as a Roth IRA, the account must be designated as such when it is established. Unlike other IRAs, an individual may make contributions to a Roth IRA beyond the individual's age of 70½.

Distributions from a Roth IRA are not included in gross income and are not subject to the 10% early withdrawal tax if certain requirements are met. In addition to other requirements, the individual must have held the Roth IRA for a five-year period beginning with the first year in which a contribution was made to the Roth IRA and ending with the end of the fifth year after the contribution.

Additionally, holders of a Roth IRA do not need to start receiving distributions by the age of 70½, as do holders of other types of IRAs.

**Federal and California law** also permits the "rollover" of a non-Roth IRA into a Roth IRA if the taxpayer's AGI for the year does not exceed $100,000 (computed without regard to the rollover distribution) and the taxpayer is not a married individual filing a separate return. The $2,000 annual contribution limit does not apply to rollovers. The rollover of an ordinary IRA into a Roth IRA requires the taxpayer to report the ordinary IRA distribution in gross income. However, if the ordinary IRA is contributed to the new Roth IRA within 60 days of the distribution, the 10% early withdrawal tax will not apply. If an ordinary IRA is rolled into a Roth IRA before January 1, 1999, the amount that is includible in gross income is included ratably over a four-year period. The law permits a rollover into or between Roth IRAs more than one time a year.

SPECIFIC FINDINGS

The **IRS Reform Act** made technical changes in the following seven areas of the Roth IRA provisions:

1. Early Withdrawals of Amounts Converted From Regular IRAs to Roth IRAs. Under the law before the IRS Reform Act, (1) the four-year income spread was mandatory, not elective, and (2) the 10% tax on early withdrawals did not apply to conversions of regular IRAs into Roth IRAs. Thus, under **federal law** before this change, taxpayers under age 59½ could escape the 10% early withdrawal penalty tax by rolling over funds from a regular IRA to a Roth IRA and then immediately thereafter taking a distribution from the Roth IRA.

The **IRS Reform Act** modifies the rules relating to conversions of regular IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth Conversion IRA while retaining the benefits of the four-year income spread as follows:

- Acceleration of income inclusion. Where amounts are converted in 1998, and are thus subject to the four-year income spread, income inclusion is accelerated for any amounts withdrawn before 2001, the fourth year of the spread. This is done by adding the amount withdrawn in that year to the amount required to be included in income in that year under the four-year income spread rule. However, a limitation to the inclusion rule is provided to prevent more than the total amount required to be included in income over the four-year period from being included in income.

- Election. The **IRS Reform Act** makes the four-year income spread elective. Once made, the election or non-election cannot be changed.

- Application of early withdrawal tax to converted amounts. If converted amounts are withdrawn within the five-year period beginning with the year of the conversion, the amount withdrawn, only to the extent attributable to amounts that were includible in income due to the conversion, will be subject to the 10% early withdrawal tax.

2. Determination of Five-Year Holding Period. Under the law before the IRS Reform Act change, the five-year holding period with respect to conversion of Roth IRAs began with the tax year of the conversion.

- Applying the five-year holding period for Roth IRAs. The **IRS Reform Act** eliminates the special rule under which a separate five-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution. Thus, the five-year holding period rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new five-year period.

- Return of excess contributions. Distributions of excess contributions and earnings allocable to the contributions are not considered qualified distributions.

- Ordering rules. Ordering rules are provided to determine which amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted). Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. Earnings will continue to be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs (regardless of whether maintained in separate accounts) are considered a single Roth IRA.

3. Corrections of Erroneous Conversions. Under the law before the IRS Reform Act change, no mechanism allowed a taxpayer to correct or “undo” an erroneous conversion, such as when a taxpayer makes a conversion early in a tax year and then discovers by the end of the year that the AGI limit of $100,000 has been exceeded and, thus, the taxpayer is ineligible to make the conversion.

The **IRS Reform Act** provides that contributions to an IRA and earnings on those contributions may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer’s return for the year of the contribution (including extensions). Any transferred contributions will be treated as if contributed to the transferee IRA and not to the transferor IRA. Any transfer of contributions must be accompanied by any net income allocable to the contributions. Also, these transfers are permitted only if no deduction was allowed with respect to the contribution to the transferor plan. These provisions are effective for tax years beginning after December 31, 1997.

4. Effect of Account Holder’s Death during Four-Year Spread Period. The **IRS Reform Act** provides that any amounts remaining to be included in income as a result of a 1998 conversion (the four-year spread) will be includible in income on the final return of the deceased taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may elect to continue the deferral by including the remaining amounts in his or her income over the remainder of the four-year period. However, that election may not be made or changed after the due date for the spouse’s tax year that includes the date of death.

5. Determination of AGI Limit for Conversions. The **IRS Reform Act** provides that AGI, for purposes of applying the $100,000 threshold, is determined in the same manner as for regular IRAs. For regular IRAs, AGI includes taxable social security and railroad retirement benefits and the application of the passive activity loss rules. However, the exclusions for interest on U.S. savings bonds used to pay higher education expenses, for employer-provided adoption assistance programs, and for foreign earned income are not taken into account in determining AGI. In addition, the deduction for a contribution to a regular IRA is not taken into account.

The **IRS Reform Act** also makes it clear that the applicable AGI is the AGI for the year of the distribution to which the conversion relates. It also clarifies that, for purposes of computing taxable income, the conversion amount is to be taken into account in computing all AGI-based phase-out amounts except for the modified AGI amount used in Roth IRA conversions.

6. Clarification of Phase-out Range. The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with AGI between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The **IRS Reform Act clarifies** that the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return is $0 to $10,000 of AGI.

7. Clarification of Contribution Limit. The **IRS Reform Act** clarifies that the maximum amount of contributions an individual may make to all of his or her IRAs is limited to a cumulative total of $2,000 per year.

The **IRS Reform Act** also provides that a simplified employee pension (SEP) or a SIMPLE IRA may not be designated as a Roth IRA and contributions to a SEP or SIMPLE IRA cannot be taken into account for purposes of the $2,000 contribution limit. Thus, contributions to a SEP or SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.

All provisions contained in the IRS Reform Act that affect Roth IRAs have an operative date for federal law for tax years beginning after December 31, 1997.

**California law** is in conformity with federal law as it relates to Roth IRAs prior to the enactment of the IRS Reform Act. Additionally, California law provides that the early withdrawal tax applied to converted amounts withdrawn within the five-year period beginning with the year of conversion.

**This provision** would conform to the IRS Reform Act technical changes relating to Roth IRA provisions discussed above.

### Implementation Considerations

This provision would be operative for taxable years beginning on or after January 1, 1999, while the federal provision was operative for taxable years beginning on or after January 1, 1998. As a result, for state purposes, a taxpayer who converted an ordinary IRA to a Roth IRA and died during 1998, the last tax return of the decedent would include an acceleration of the converted amount (100% instead of 25%) and the early withdrawal penalty of 2½%. Further, taxpayers would be required to spread the conversion amount over four years rather than elect to take the amount into income during 1998.

## FISCAL IMPACT

### Departmental Costs

This provision would not significantly impact the department’s costs.

### Tax Revenue Estimate

Revenue losses are estimated to be minor. The minor revenue losses would be losses of penalties and revenues that were not anticipated.

## 5. Innocent Spouse

OPERATIVE DATE

This provision would apply to any liability for tax arising after the effective date of this bill and any liability for tax arising on or before the effective date, but remaining unpaid, as of that date.

SPECIFIC FINDINGS

**Under prior federal law**, spouses who filed a joint tax return were each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

**Prior federal law** provided relief from liability for tax, interest and/or penalties for "innocent spouses." To qualify for innocent spouse relief, the innocent spouse was required to establish that:

- A joint return was made;
- An understatement of tax, which exceeded the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income (AGI) for the most recent year, was attributable to a "grossly erroneous" item of the other spouse;
- In signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and
- It was inequitable to hold the innocent spouse liable for the deficiency in tax.

The specified percentage of AGI was 10% if AGI was $20,000 or less. Otherwise the specified percentage was 25%. Grossly erroneous items include items of gross income omitted from reported income and claims of deductions, credits or basis in an amount for which there is no basis in fact or law.

**Current federal law** also provides relief for innocent spouses with respect to community property income not included on the separate return of a married person.

**The IRS Reform Act** makes innocent spouse status easier to obtain by eliminating all understatement thresholds and by requiring only that the understatement of tax be attributable to an erroneous item of the other spouse. Relief may be provided on an apportioned basis. An innocent spouse may be relieved of liability for the portion of an understatement of tax if the spouse did not know or have reason to know of the understatement of tax and it would be inequitable to hold the taxpayer responsible for the deficiency.

**The IRS Reform Act** provides a separate liability election for a taxpayer who, at the time of the election, is no longer married to, is legally separated from, or for at least 12 months has been living apart from the spouse. The taxpayer has two years from the date the IRS begins collection action to make this election. The IRS Reform Act provides that the Tax Court has jurisdiction over disputes arising from the separate liability election. The IRS Reform Act requires the

IRS to notify all taxpayers who have filed a joint return of their right to elect separate liability.

**The IRS Reform Act** expanded the relief provided for married persons filing separate returns to include relief for unpaid tax or any deficiency relating to the separate return that did not qualify for relief under current law.

**Under current state law**, as with prior federal law, spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability (joint and several liability).

**Current state law** also provides relief from liability for tax, interest and/or penalties for "innocent spouses" if it is inequitable to hold that spouse liable for the understatement. To qualify for innocent spouse relief, the innocent spouse must have filed a joint tax return and did not know, or had no reason to know, of the understatement. The spouse must be innocent with respect to the entire understatement.

**Current state law**, as with prior federal law, also provides relief for innocent spouses with respect to community property income not included on the separate return of a married person.

**Current state law,** in the case where the self-assessed tax has not been fully paid, requires FTB to provide the other spouse with 30 days notice of any determination to provide relief to the innocent spouse so that the other spouse may appeal the determination.

**This provision** would conform, with modifications, state law to the innocent spouse provisions of the IRS Reform Act, including the separate liability election. Modifications to the IRS Reform Act would (1) send appeals of FTB innocent spouse determinations to the BOE rather than Tax Court and (2) expand the provision requiring FTB to provide 30-day notice to the other spouse to apply to assessments as well as underpaid self-assessed tax so that the other spouse may appeal an innocent spouse determination.

**Under this provision**, pursuant to procedures prescribed by FTB, equitable relief can be granted to an innocent spouse as the facts and circumstances warrant.

Policy Considerations

This provision would allow individuals to obtain relief even though they might have been the primary beneficiary or person in control of the household income, though not the person earning the income. However, this is mitigated to some extent since the election would be invalid if FTB demonstrates that the assets were transferred as part of a fraudulent scheme to avoid taxes or the department demonstrates that the individual making the election had actual knowledge at the time the return was filed.

Implementation Considerations

Collections Bureau staff is already experiencing a slight increase in workload because of the federal provision and expects an even greater impact from this provision since more taxpayers would qualify for innocent spouse relief. Further, due to the complex nature of questions regarding this issue, any calls would be referred to staff in the Collections Bureau with expertise in this area. The taxpayer information (TI) system would need modification to issue separate notices and maintain separate but equal liabilities. To the extent information may need to be retained on the collection system, this provision would impact the new personal income tax collection system (ARCS) design and/or strategies.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this provision are preliminary. It is estimated that the costs would range from $598,000 to $798,000 for the first year and $176,000 annually thereafter. The majority of the first year cost ($400,000 to $600,000) would be required to program and test changes to the TI system. The remaining first year cost and ongoing costs would be required to increase Collection Bureau staff (three senior compliance representative positions).

Tax Revenue Estimate

Current law provides innocent spouse relief under certain circumstances. The incremental impact of conforming to proportionate liability would result in minor revenue losses, on the order of $500,000 annually.

## 6. Employee Relief/Unremitted Withholdings

OPERATIVE DATE

This provision would be operative for determinations made by FTB on or after January 1, 1999, and the unremitted amounts were withheld no earlier than six years before FTB mailed its deficiency assessments.

SPECIFIC FINDINGS

In general, Employment Development Department (EDD) administers various laws that provide for employer taxes on wages (earnings), including the withholding of personal income taxes. When employers are required to withhold and remit personal income taxes on their employee earnings, they remit the withheld earnings to EDD. If an employer fails to remit personal income taxes on employees' earnings as required, the employer is liable to EDD for the taxes.

FTB administers, among other laws, the Personal Income Tax Law (PITL). If the FTB determines a tax deficiency exists, the FTB mails a notice of proposed assessment (NPA) and the taxpayer has an opportunity to protest and appeal FTB's determination. Such notices may be mailed when taxpayers make errors on their tax return or when someone other than the taxpayer is specifically liable for the taxpayer's taxes because of actions that other person took (secondary liability).

When a final personal income tax assessment is due and payable and is not voluntarily paid, FTB takes administrative collection action that does not require prior judicial action. It also takes administrative collection actions to collect certain other debts (child support delinquencies, vehicle registration, court-ordered debts, etc.) as though they are final personal income tax assessments.

One such action is the issuance of an earnings withholding order for taxes (EWOT) pursuant to the Code of Civil Procedure. These orders require employers to withhold delinquent taxes from an employee's earnings and remit the withheld earnings to FTB. In the event the employer fails to remit the withheld amount to the FTB, the FTB may bring a civil action against the employer to recover the amount that should have been remitted. Once a judgment is rendered, FTB may collect the unremitted amount from the employer.

During the pendency of collection of a secondary liability or judgment, both the taxpayer and employer are liable for the amount due. Collection is not stayed against either party. At the point of collection, the accounts are adjusted accordingly. If the debt were collected from the employer, the amount is transferred to the taxpayer's account and the employer's liability is cancelled. If collected from the taxpayer, the taxpayer's account is credited and the employer's liability is cancelled.

If an employer files bankruptcy, the taxpayer may file a claim in bankruptcy court for his or her nonremitted earnings. The taxpayer has a better chance of collection than other creditors because earnings receive a higher payment priority than other types of debt, including taxes.

FTB has no authority to credit the account of the taxpayer for the amount that the employer withheld and failed to remit. This failure to remit withheld amounts may occur several times a year. In addition, FTB does not have the authority to stay collection against the taxpayer.

**This provision** would provide relief to an employee whose employer withheld delinquent PITL taxes from the employee's pay, pursuant to an EWOT, but failed to remit the amounts to FTB. Specifically, this bill would:

- Eliminate the taxpayer's liability for the unremitted amount by allowing FTB to credit the taxpayer's account for the unremitted amount.

- Hold the employer liable for the unremitted amount by allowing FTB to administratively assess an amount equal to the unremitted amount against the employer, without a civil action.

- Preserve the employer's protest and appeals rights in the event the employer disputes the records of the taxpayer. Collections would be pursued from the employer only after the NPA is final and due and payable.

- Stay collection against the taxpayer for the amount at issue for the period between the time that FTB determined a failure to remit and the employer's NPA is either final and due and payable, withdrawn or revised, and the taxpayer notified thereof.

- Provide FTB with a six-year statute of limitation for making the proposed assessment (from the date the employer first failed to remit) in order to provide the taxpayer with ample time to find out the employer failed to remit and bring the matter to the FTB for investigation.

- Preclude the taxpayer from collecting another amount equal to the credit through a bankruptcy proceeding or other remedy.

Implementation Considerations

This provision could be implemented with minor changes to FTB's current collection programs.

FISCAL IMPACT

Departmental Costs

Departmental costs should not increase significantly.  The resources currently spent to explain current law to the few affected taxpayers and evaluating when a civil action would be an effective collection remedy could be shifted to accommodate implementation of this provision.

Tax Revenue Estimate

This provision would have negligible impact on collections of PIT taxes (minor losses on the order of $25,000 annually).

## 7. SOL/Disabled Taxpayers

OPERATIVE DATE

This provision would apply to all periods of disability before, on or after the effective date of this bill.  However, it would not apply to any claim barred by the SOL as of the effective date.

SPECIFIC FINDINGS

**Current federal law** requires a taxpayer to file a claim for refund within three years of the filing of the return or within two years of the payment of tax, whichever period expires later (if no return is filed the two-year limit applies).  A refund claim that is not filed within these time periods is rejected as untimely.

**The IRS Reform Act** suspends the SOL for certain refund claims for a period where the taxpayer is "financially disabled."  Individuals are "financially disabled" if they are unable to manage their financial affairs because of a medically determinable physical or mental impairment that is expected to result in death or to last for a continuous period of at least one year.  An individual would not be financially disabled for any period that the individual's spouse or any other person is legally authorized to act on that individual's behalf in financial matters.

**Current state law** requires a taxpayer to file a claim for refund within four years from the due date (without regard to extensions) or one year from the date of payment of tax, whichever is later.  In the case of a California waiver of the

SOL, the period for filing a claim for refund is the period of the waiver or one year from the date of overpayment, whichever is later. In the case of a federal waiver, the period for filing a claim for refund is six months from the expiration of the federal waiver.

**Current state law** requires the taxpayer to notify FTB if the amount of gross income or deductions reported to the IRS for any year is changed, either by the taxpayer or federal authorities. The taxpayer has six months from the final federal determination date to report the change to FTB. Claims for refund must be filed within two years from the date of the final federal determination.

**Current state law** allows taxpayers to file a claim for refund up to seven years after the due date of the return in the case of bad debts, worthless securities or erroneous inclusion of recoveries.

**This provision** would conform state law to the IRS Reform Act provisions to suspend the SOL for certain refund claims when the taxpayer is “financially disabled.”

Implementation Considerations

Implementation of this provision would occur during the department’s normal annual system update.

FISCAL IMPACT

Departmental Costs

This provision would not significantly impact the department’s costs.

Tax Revenue Estimate

Revenue losses from additional refunds issued would be on the order of $1 million annually based on federal projections.

## 8. Offers In Compromise

OPERATIVE DATE

This provision would be operative for compromises made on or after January 1, 1999, without regard to when the offer is made, or to taxable or income years to which such offer relates.

BACKGROUND

When a final personal income or bank and corporation tax liability is not paid by a taxpayer when due, FTB’s automated collection system will bill the debtor, search for the tax debtor’s assets and take collection actions to use the asset(s) to satisfy the tax debt. For example, depending upon the type of asset, the automated collection system can issue an order to withhold funds in bank accounts, an order to attach wages and certain other business income in the case of an individual, or file a lien in the county of the address of record. For certain cases, the account is referred for manual collection actions, which may include manually searching records for assets, making telephone calls, or seizing and selling vehicles, vessels, or stocks.

In the event of a hardship, payment arrangements may be made or collection may be deferred until the financial situation of the tax debtor improves. However, if tax debtors can obtain loans or can use credit lines to pay their tax debts, they are expected to do so.

If a debt remains unpaid for a number of years, a lien has been filed and assets cannot be located, FTB may be discharged from collecting the debts under the Government Code (discharged from accountability). When a debt is discharged, the debt is still due and owing, but routine billings and collection actions are discontinued unless assets are subsequently located. There are no statutes of limitation on FTB's collection of a tax debt, and interest and applicable penalties continue to accrue.

OFFERS IN COMPROMISE

In general, an offer in compromise is a process whereby the debtor offers to pay an amount that he or she believes to be the maximum amount that can ever be paid on a debt. If the parties agree to the amount offered, the debt is compromised (reduced) to that amount. The tax debtor may be required to promise to pay a specified percentage of any future increases in income, which is termed a "collateral agreement," as part of the compromise.

The IRS and EDD have the authority to administratively compromise final tax debts that are due and payable and the processes and procedures generally are similar. However, the oversight/review provisions differ. For EDD, the specific criteria for a compromise and its procedures and processes are codified. For the IRS, the codified authority for a compromise is general in nature. Regulations and case law generally set forth the federal procedures and processes:

- Under the Internal Revenue Code (IRC), under which relevant regulations have been adopted, **IRS may administratively compromise** a tax debt when there is doubt:

    - as to the ability to collect the full amount owed, and/or
    - as to the validity of the actual tax liability.

When a compromise is made, a statement must be placed on file as to the amount of the assessed liability and the amount paid under the terms of the compromise.

In those cases where the unpaid amount of tax assessed, including any interest, additional amount, additions to tax or assessable penalty, is $50,000 or more, the opinion of the Chief Counsel of the IRS as to the reason for the compromise must be included in the filing. Under regulations, compromises involving liabilities of $100,000 or more, generally, receive internal high level review, and for one year, the information on file is available to the public. The IRS is prohibited from distributing lists or releasing information in connection with the cases.

If a person defaults on the terms of the agreement, which includes filing returns and paying the required taxes for five years following acceptance of the offer, the IRS may take various judicial actions or may disregard the compromise and may proceed to collect any amount that remains unpaid.

Under the IRC, if a person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition, the tax debtor is guilty of a felony. Upon conviction, the person shall be fined not more than $100,000 ($500,000 for corporations), or imprisoned not more than three years, or both, and required to pay the costs of prosecution.

- Under the Unemployment Insurance Code, **EDD may administratively compromise** a tax debt only when certain specified criteria are met, as follows:

    - the debtor must be out of business or no longer have an interest in or be associated with the business;
    - the debtor cannot have access to income sufficient to pay more than the accruing interest and 6.7% of the liability on an annual basis;
    - the debtor cannot have reasonable prospects of acquiring increased income or assets that would enable the debtor to liquidate the liability in a reasonable period; and
    - the amount offered is more than the department could reasonably expect to collect during the four years following the date of the agreement.

    Reductions of $10,000 or more must be approved by the Unemployment Insurance Appeals Board. This authority has been delegated to an administrative law judge. Once the terms of the agreement are met, a statement is placed on file and available to the public for one year. The statement must identify the debtor, reason for the compromise, total unpaid amount at issue, total amount paid under the compromise and terms thereof. EDD is prohibited from distributing lists or releasing information in connection with the cases.

    If a tax debtor conceals property, withholds or falsifies any records with respect to the taxpayer's financial condition, or fails to pay subsequent tax liabilities, the compromised amount of the debt is reinstated and the entire unpaid amount is due and payable.

The FTB does not have the administrative authority to compromise a tax debt, but instead must bring a civil action in court against the tax debtor, an authority delegated by the Attorney General (AG), as discussed below.

Related to an offer in compromise is the ability to administratively **settle** (reduce) a tax matter that is not final or due and payable and is in dispute. The FTB, BOE, and IRS have administrative settlement authority. The amount in dispute is settled during the appeal process. Settlements are determined based on the costs and risks associated with litigation of the matter. For FTB, if the reduction in tax and penalties is in excess of $5,000, recommendations for approval are made to the FTB, itself, after review by the AG as to whether the recommendation is reasonable from an overall perspective. For reductions under $5,000, the executive officer and chief counsel jointly approve the recommendations. There is a public record for settlements where tax and/or penalties exceed $500. The record includes the taxpayer's name, the total amount in dispute, the agreed amount, the reason it is in the best interest of the state, and, for those over $5,000, the AG's opinion.

If any person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition in conjunction with a settlement, the person is guilty of a felony.  Upon conviction, the person shall be fined up to $50,000 ($200,000 for banks and corporations), or imprisoned not more than three years, or both, and required to pay the costs of investigation and prosecution.  This criminal penalty conforms to that provided under the IRC for settlements (and compromises), except the amount of the fine is less for California purposes.

SPECIFIC FINDINGS

**Under current law and FTB practice**, taxes administered by FTB may be compromised only based on doubt as to the collectibility and through the AG's statutory authority to obtain a judgment against the tax debtor to collect the tax debt, which the AG has delegated to FTB for purposes of compromising the debt.  After the offer is reviewed for completeness and reasonableness, FTB collects the amount offered and the review process commences, with final approval by the executive officer and the chief counsel jointly.  A stipulated judgment is obtained followed by the filing of a satisfaction of the judgment when all terms of the agreement, including collateral agreements, have been met.

As part of the offer in compromise process, FTB staff must prepare the legal documents, keep track of the court's calendar for filing the documents, and submit payment of the court fees (costs).  As the plaintiff in this civil action, the FTB is responsible for paying the court costs; however, as a condition of the compromise, the tax debtor must agree to pay the court costs.  The costs are then paid by FTB from the amount offered in compromise.  The court documents, which include a stipulation setting forth the terms of the compromise and whether the offer is based on the terms of a collateral agreement, are a matter of public record.

In the offer in compromise procedure, FTB generally follows the IRS procedures and EDD's law with respect to:

- the terms of the offer, which requires the filing of tax returns and payment of taxes generally for five years following the compromise;
- the process leading up to the acceptance of the offer, including high levels of review; and
- the refunding of rejected offers, at the taxpayer's discretion and without interest.

In determining whether an offer in compromise is acceptable, EDD and IRS each consider factors unique to the taxes that they administer, which are not applicable to taxes administered by FTB.  With EDD, its taxpayers are all businesses that have had employees and by statute must be out of business; IRS is constrained by a 10-year statute of limitation on collection.  Therefore, because these factors are important to EDD and IRS decision-making, but not to FTB, there may be cases where an offer could be acceptable to one agency but not others.

Recently, staff has reexamined its perspective used in the offer in compromise process and has changed its practice so that staff is working toward better communication with taxpayers and their agents in resolving matters relative to this process.  Under current practice, staff expects to compromise approximately

200 cases for fiscal year 1998/99. In 1997/98 fewer than 100 cases were compromised and where in previous years there were only 12 to 24 cases compromised.

**This provision** would provide FTB with administrative authority to compromise a tax debt, comparable to the authority provided the IRS. For the smaller compromises (reductions in tax of $7,500 or less), the executive officer and chief counsel, jointly, could compromise the debt or delegate the authority to others within the department. For those cases in which the reduction in tax exceeds $7,500, the FTB, itself, would have the authority to compromise the debt upon recommendation by staff. However, for those cases in which the reduction in tax exceeds $7,500, but is less than $10,000, the FTB, by resolution, could delegate to the executive officer and chief counsel, jointly, its authority to compromise the debt. A public record would be placed on file, comparable to those required by laws governing EDD and IRS offers in compromise and FTB's settlement procedure. The record would include a summary statement as to why the compromise would be in the best interest of the state.

In addition, **this provision** would provide clearly articulated enforcement tools in the event of a default on the terms of the agreement, or if any person conceals property or generally withholds or falsifies any records with respect to the taxpayer's financial condition in conjunction with a compromise.

### Implementation Considerations

This provision could be implemented without significant changes in procedures. Staff would no longer be required to prepare the court documents and conduct court-related activities, or issue checks for payment to the court. It is anticipated that the department under this provision would process fewer additional payments.

## FISCAL IMPACT

### Departmental Costs

As a result of this provision, the amount the department expends for its costs related to the stipulated judgments/civil actions process would be saved, however, the amount is anticipated to be insignificant in terms of FTB's total budget.

### Tax Revenue Estimate

The revenue savings from this provision would be minimal, on the order of $40,000 annually.

Under this provision, for each case the department compromises, taxpayers would pay the department the amount they would otherwise have paid in court costs (averaging approximately $400). It is estimated that approximately 100 cases would be compromised annually. The court costs are $375 for one defendant and $555 for two (married individuals who file joint returns).